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[REDACTED] - Subpart F Partnership Issues

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You made a telephone inquiry to our office in connection with a nondocketed case in which taxpayers assert that amounts paid to a partnership as commission income are not subpart F income of the controlled foreign corporation (CFC) that is a partner of the partnership. You requested informal written assistance during a telephone conversation in which the various issues, and our responses, were discussed. For the reasons described below, we have concluded that the commission income paid to the partnership is sales income of the partnership, and that such income should properly be characterized as foreign base company sales income at the partner level. Therefore, the CFC's distributive share of such income would be subpart F income.

A summary of the facts described by you in our telephone conversation are as follows. [REDACTED] is the domestic corporate parent of [REDACTED], a domestic corporation that owns all of the stock of a controlled foreign corporation (CFC) organized in the [REDACTED]. CFC is an [REDACTED] percent partner in a [REDACTED] partnership (Partnership). Partnership has one other partner, which is an entity unrelated to [REDACTED] and its affiliates. Partnership purchases [REDACTED] from a [REDACTED] company, which also is unrelated to [REDACTED] and its affiliates, as agent for [REDACTED]. The [REDACTED] company ships its [REDACTED] directly to [REDACTED], and title passes from the [REDACTED] company to [REDACTED]. As part of the sales transaction, [REDACTED] pays an amount characterized as a commission to the Partnership. The taxable years at issue ended before 1987.

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In general, a U.S. shareholder of a controlled foreign corporation is required to include currently in its gross income its share of the subpart F income of the controlled foreign corporation, described in sections 951 through 964 of the Code. Section 954(d)(1) provides that foreign base company sales income, a category of subpart F income, includes commission income derived in connection with the purchase of personal property on behalf of a related person where the property is manufactured outside the country in which the controlled foreign corporation is organized. For taxable years ending before 1987, section 954(d)(3) defined related person to include a corporation controlled by a controlled foreign corporation. However, a partnership in which a controlled foreign corporation was a controlling partner was not a related person within the meaning of section 954(d)(3).¹

We have been asked whether CFC's distributive share of the Partnership's commission income is subpart F income. Taxpayer argues that for purposes of section 954(d), and pursuant to MCA Inc. v. United States, 685 F.2d 1099 (9th Cir. 1982), the character of Partnership's commission income is determined at the partnership level. Because Partnership is not a person related to [REDACTED] within the meaning of section 954(d)(3), taxpayer argues that its commission income is not income derived in connection with the purchase of personal property on behalf of a related person. Accordingly, CFC's distributive share of such income is not foreign base company sales income under section 954(d).

¹ Section 1221(e)(1) and (e)(2) of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act"), amended section 954(d) to provide that a controlled partnership would qualify as a related person. The legislative history states that the exclusion of controlled partnerships from the definition of related person is without logic. See H. R. Rept. No. 426, 99th Cong., 1st Sess. 403 (1985); see also H. R. Rept. No. 247, 101st Cong., 1st Sess. 1417 (1989) (in describing an amendment to section 954 in later bill, refers to purpose of amendment to section 954(d)(3) made under the 1986 Act). The 1986 Act amendment addresses the situation presented in MCA Inc. v. United States, 685 F.2d 1099 (9th Cir. 1982), discussed below, in which a partner receives income from a controlled partnership in its capacity other than as a partner in the partnership. The amendment to section 954(d)(3) has no bearing on the outcome of the present case, since the case does not require a determination of the character of payments by a controlled partnership to a partner (in its capacity other than as a partner in the partnership), but the character of a partner's distributive share of the partnership's income.

The holding of the court of appeals in MCA Inc. does not apply under the facts of this case. In MCA Inc., which involves taxable years ending before 1987, a controlled foreign corporation and a related employee trust formed 29 distributorships in various foreign countries to distribute the films of the controlled foreign corporation's corporate parents. The controlled foreign corporation was paid royalties from the distributorships for licensing the films. At issue was whether such royalties were subpart F income of the controlled foreign corporation.

Pursuant to section 954(c)(1) of the Code, foreign personal holding company income includes royalties unless either of two exceptions applies: pursuant to section 954(c)(3)(A), if the royalties are derived in the active conduct of a trade or business and are received from other than a related person; or, pursuant to section 954(c)(4)(C), if the royalties are received from a related person for the use of property within the country in which the controlled foreign corporation is organized.² As noted above, a related person as defined under section 954(d)(3) does not include a controlled partnership.

The issue before the court was whether the distributorships should be characterized as partnerships or as corporations. If characterized as corporations, the royalty income received from the distributorships would be royalties received from a related party. Such income therefore would not qualify for the exception provided in section 954(c)(3)(A) or section 954(c)(4)(C), and therefore would be subpart F income.³ The appellate court determined, however, that the distributorships were properly characterized as partnerships. Because such entities were not persons related to the controlled foreign corporation for purposes of section 954, the controlled foreign corporation's royalty income received from the partnerships was not subpart F income because it was excepted from foreign personal holding company income under the active trade or business exception of section 954(c)(3)(A).

In MCA Inc. the royalties were paid to the controlled

² Amendments made by section 1221(a)(1) of the 1986 Act in effect redesignated these rules as section 954(c)(2)(A) and (c)(3)(A)(ii) of the Internal Revenue Code of 1986.

³ Two issues were not discussed by the court: first, whether the exception described in section 954(c)(3)(A) applied; and second, whether the character of the partner's distributive share of partnership income, if any, was determined at the partnership or the partner level.

foreign corporation in its capacity other than as a partner in the partnership. See section 707 of the Code. In other words, the partnership paid royalties to the controlled foreign corporation not because the controlled foreign corporation was a partner in the partnership, but because the corporation licensed the rights to distribute films to the partnership. The partnership would have paid the royalties under such an arrangement even if the controlled foreign corporation was not a partner in the partnership. The characterization of the controlled foreign corporation's distributive share of the partnerships' income, in its capacity as a partner in the partnerships, was not at issue in that case. Thus, MCA Inc. has no bearing on the outcome of the present case.

Pursuant to revenue ruling 89-72, 1989-1 C.B. 257, the character of CFC's distributive share of the Partnership's income is determined as if the income had been earned directly by CFC. CFC is thus itself treated as having made purchases of [REDACTED] from the [REDACTED] companies on behalf of [REDACTED] and [REDACTED], which are related persons within the meaning of section 954(d)(3) of the Code. ([REDACTED] and [REDACTED] are corporations that control CFC.) Therefore, CFC's distributive share of commission income is properly characterized as foreign base company sales income within the meaning of section 954(d).

You stated that taxpayers raised the additional argument that the character of a partner's distributive share of partnership income is determined at the partnership level, for purposes of subpart F, pursuant to section 1.954-6(g) of the regulations. This provision states explicitly that foreign base company shipping income, a category of subpart F income, includes a partner's distributive share of partnership income to the extent such income would have been treated as subpart F income if earned by the partner directly. Taxpayers argue that the absence of explicit look-through rules for partnership income for purposes of other subpart F income categories implies that an opposite result obtains for such categories; namely, that the character of a partner's distributive share of partnership income for subpart F purposes is determined at the partnership level.

This argument does not have merit. As argued in revenue ruling 89-72, the partnership provisions of subchapter K of the Code, sections 701 through 761, compel the conclusion that the character for subpart F purposes of a partner's distributive share of partnership income is determined at the partner level. No inference should be drawn from the fact that this rule is articulated explicitly only in section 1.954-6 of the regulations, which describes foreign base company shipping income. There is no logical basis to provide different rules for the separate categories of subpart F income to determine the

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character of a partner's distributive share of partnership income. No provision of the regulations under section 954(c) indicates that such a distinction is to be made. For these reasons, taxpayers arguments should be rejected.

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If you have any additional questions or comments, please call Jim Sams at FTS-566-6645.